

Gina Harrison  
Director  
Federal Regulatory Relations

1275 Pennsylvania Avenue, N.W., Suite 400  
Washington, D.C. 20004  
(202) 383-6423

**PACIFIC X TELESIS**  
Group-Washington

December 19, 1996

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Mr. William F. Caton  
Acting Secretary  
Federal Communications Commission  
1919 M Street, NW, Room 222  
Washington, DC 20554

Dear Mr. Caton:

Re: *CC Docket No. 96-45, Federal-State Joint Board on Universal Service*

On behalf of Pacific Telesis Group, please find enclosed an original and six copies of its "Comments" in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

*Alan Thompson*

Enclosure

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Before the  
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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF SECRETARY

In the Matter of

Federal-State Joint Board on  
Universal Service

CC Docket No. 96-45

**COMMENTS OF PACIFIC TELESIS GROUP**

MARLIN D. ARD  
SARAH R. THOMAS

140 New Montgomery Street  
Room 1522A  
San Francisco, California 94105  
(415) 542-7649

MARGARET E. GARBER

1275 Pennsylvania Avenue, N.W.  
Washington, D.C. 20004  
(202) 383-6472

Attorneys for Pacific Telesis Group

Date: December 19, 1996

## **TABLE OF CONTENTS**

## **PAGE**

SUMMARY .....	v
I. INTRODUCTION .....	1
II. THE JOINT BOARD'S RECOMMENDED DECISION, IF ADOPTED, WILL VIOLATE THE STATUTORY MANDATE FOR ENSURING SUFFICIENT UNIVERSAL SERVICE SUPPORT FOR RURAL, INSULAR AND HIGH COST AREAS.....	3
A. Implementation Of The Joint Board's Cost Model Principles Inevitably Will Understate Universal Service Costs.....	6
1. All ILECs Must Be Provided An Opportunity To Recover Their Legacy Costs.....	6
2. If The Commission Adopts A Cost Model Using Forward-Looking Costs, Actual ILEC Data Must Be Used To Predict Costs.....	10
3. The Commission Should Adopt The Joint Board's Recommendation That A Reasonable Share Of Joint And Common Costs Be Included In The Calculation Of Supported Costs.....	13
4. Any Cost Proxy Model That Utilizes Forward-Looking Costs Must Also Use Forward-Looking Demand To Avoid Underestimating Unit Support Costs.....	14
5. Underlying Data Used In Any Cost Model Must Be Auditable And Verifiable By Interested Parties And Relevant Data Inputs Must Be Mutable.....	14
B. The Joint Board's Nationwide Benchmark Is Likely To Be Unreasonably High And Thus Undercompensate Carriers That Need Universal Service Support.....	16
1. The Cost Model Does Not Contain Costs Associated With Discretionary Or Access Services.....	16
2. Inclusion Of Discretionary And Access Service Revenues In The Benchmark Violates The Act's Requirement That Subsidies Be Explicit And Predictable.....	17
3. The Benchmark Should Include Only The Revenue Associated With The Supported Services .....	18
C. The Commission Must Make Explicit The Size Of And The Precise Method and Formula For Assessing Contributions To The High Cost Fund .....	18
D. High Cost Support Should Be Provided for All Residential Lines .....	19
III. PROHIBITING HIGH COST FUND CONTRIBUTORS FROM RECOVERING CONTRIBUTIONS FROM THEIR SUBSCRIBERS IS PATENTLY UNCONSTITUTIONAL AND NOT COMPETITIVELY NEUTRAL .....	20

## **TABLE OF CONTENTS**

## **PAGE**

A. Failure To Permit High Cost Fund Contributors From Recovering Their Costs Would Constitute An Unconstitutional Taking .....	21
B. Failure To Permit Recovery Is Not Authorized By Section 254 Or Any Other Section Of The Act .....	22
C. ILECs Would Be Competitively Disadvantaged If They Are Prohibited From Recovering High Cost Fund Contributions From Their Subscribers.....	22
IV. THE COMMISSION MAY ASSESS CONTRIBUTIONS BASED ON BOTH INTER- AND INTRASTATE REVENUES.....	23
V. THE COMMISSION SHOULD CLARIFY HOW USERS OF UNBUNDLED ELEMENTS ARE TO BE ASSESSED FOR HIGH COST FUND PAYMENTS.....	24
A. The Commission Should Define How High Cost Assistance Will Be Apportioned When Part Of The Network Elements For A Customer Are Provided By The ILEC And Part Are Provided By A CLEC.....	24
B. The Commission Should Clarify Paragraph 808 So That ILECs May Assess Users Of Unbundled Elements For High Cost Fund Contributions .....	27
VI. THE COMMISSION SHOULD NOT CAP INTERSTATE SUBSCRIBER LINE CHARGES, AND SHOULD ENSURE THAT IF THE CARRIER COMMON LINE CHARGE IS REDUCED OR ELIMINATED, IT IS MADE A PART OF THE UNIVERSAL SERVICE FUND .....	27
A. The Joint Board's Proposed SLC Reductions Will Increase Implicit Subsidy, Contrary to the 1996 Act.....	27
B. The Carrier Common Line Charge Must Be Made An Explicit Part of the Universal Service Fund If It Is Lowered by The Commission .....	29
VII. THE JOINT BOARD'S LOW-INCOME PROPOSALS WILL NOT ENHANCE SUBSCRIBERSHIP AND WILL INCREASE BAD DEBT; THE COMMISSION SHOULD INSTEAD RELY ON MARKET-DRIVEN INDUSTRY INITIATIVES .....	30
A. We Support Voluntary Toll Limitation Services, If They Are Supported By The Fund .....	30
B. We Oppose A Rule Prohibiting Disconnection for Non-Payment of Toll .....	31
1. The No-Disconnect Rule Will Not Increase Subscribership .....	32
2. Pacific Has Improved Subscribership Rates Through Creative Partnerships With Community Leaders and Outreach Programs; It Should Also Be Allowed To Develop Flexible Solutions To Help Customers Control Toll Use.....	33

## **TABLE OF CONTENTS**

	<b><u>PAGE</u></b>
3. The No-Disconnect Policy Will Increase Drastically the Industry's Net Bad Debt and Increase Our Operational Expenses, and We Will Not Be Adequately Protected by Toll Limitation Services .....	34
4. The Standards for Obtaining A Waiver Should Be Relaxed .....	36
5. The Commission Lacks Authority to Require a No-Disconnect Policy .....	36
VIII. WE SUPPORT MANY OF THE JOINT BOARD'S PROPOSALS FOR SCHOOLS AND LIBRARIES, BUT OPPOSE INCLUSION OF THE INTERNET AND INTERNAL CONNECTIONS.....	37
A. The Joint Board's Recommended Method For Subsidizing Internet Access Is In Conflict With Section 254, Ignores The Current Subsidy, And Would Further Skew Access Pricing .....	37
1. Section 254 Does Not Allow Directly Subsidized Discounts For Internet Access Service .....	37
2. In Order To Avoid Further Skewing Of Access Subsidies And Pricing, The Commission Must Consider The Relationship Between The Joint Board's Recommendation And The Existing Access Charge Exemption Enjoyed By Enhanced Service Providers .....	41
B. Internal Connections Should Not Be Included Among the Services Required for Schools and Libraries .....	44
C. The Joint Board's Recommendation Must Be Reconciled With State Commissions' CPUC's Universal Service Program For Schools, Libraries and Other Organizations .....	47
D. The Proposed Discount Methodology Requires Clarification.....	48
1. The Commission Should Clarify the Rules For Determining the "Lowest Corresponding Price" .....	48
2. We Generally Support the Joint Board's Discounts, But Suggest Minor Changes.....	51
3. Existing Special Rates Should Be Preserved in Appropriate Cases .....	52
E. Schools and Libraries Or the Fund Administrator Should Be Responsible for Recordkeeping in the Event Of Participation in Consortia.....	52
F. The Joint Board Neglected A Key Issue -- Equity in Fund Distribution .....	53
IX. THE JOINT BOARD'S PROPOSALS REGARDING HEALTH CARE NEED A GREAT DEAL OF MODIFICATION.....	54
A. Services Eligible For Universal Service Funding Must Be Commercially Available and Necessary to Congress' Stated Goals .....	54
B. Pricing of Rural Health Care Services Should Not Equalize Distance Charges .....	56

---

## **TABLE OF CONTENTS**

### **PAGE**

C. The Commission May Not Require Toll Free Internet Access Service.....	57
D. There Is No Basis For Requiring Carriers to Build Out Facilities Where None Exist.....	58
X. WE AGREE WITH THE JOINT BOARD'S PROPOSALS REGARDING THE FUND ADMINISTRATOR .....	60
XI. CONCLUSION.....	60

**COMMENTS OF PACIFIC TELESIS GROUP**  
**ON JOINT BOARD'S RECOMMENDED DECISION**

**SUMMARY**

Pacific Telesis Group comments the Joint Board for its hard work in beginning the process of implementing Section 254 of the Telecommunications Act of 1996. However, much remains to be done. Our comments make the following points:

- The Joint Board's approach to proxy modeling underestimates our costs. Any model adopted should allow us to recover our legacy costs and a reasonable share of joint and common costs;
- The Joint Board's nationwide pricing benchmark is likely to be unreasonably high because it includes discretionary and access service revenues, and thus will undercompensate carriers for their universal service support and inappropriately preserve implicit subsidies;
- The Commission must make explicit the size of and the precise formula for assessing contributions to the high cost fund;
- The Commission must allow carriers to pass on their universal service contributions to customers;
- We support a universal service fund based on both intra- and interstate revenues which is sufficient to cover our support obligations;
- The Commission should clarify how users of unbundled elements will receive universal service distributions; we advocate dividing the subsidy between the retail and wholesale carriers;

- We oppose a reduction in the cap on Subscriber Line Charges. We also believe that if any reductions in access charges come about as a result of the upcoming access reform docket, they should be reflected in greater allocations to the universal service fund;
- The Commission should reject a rule prohibiting disconnection of Lifeline customers for non-payment of toll charges; market-driven solutions will be much more effective in keeping customers on the network;
- We support the Joint Board's discount structure for schools and libraries, but oppose the inclusion of Internet access and internal connections; in addition, the Commission must determine how the \$2.25 billion fund will be divided among eligible schools and libraries; and
- We oppose any requirement that we build out our network to provide rural health care services, and advocate equalization of distance-sensitive *rates* but not the mileage against which those rates are applied.

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Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

In the Matter of

Federal-State Joint Board on  
Universal Service

CC Docket No. 96-45

**COMMENTS OF PACIFIC TELESIS GROUP**  
**ON JOINT BOARD'S RECOMMENDED DECISION**

I. **INTRODUCTION**

Pacific Telesis Group ("Pacific") hereby submits comments on the Joint Board's recommendations for conforming the nation's universal service rules to the Telecommunications Act of 1996. We commend the Joint Board for its work, and recognize the effort it put into resolving what are very difficult and far-reaching issues. We believe the Joint Board has resolved a number of issues correctly -- for example, its decision to rely on proxy models.

Must remains to be done, however. It is imperative that the Commission solve a number of significant problems in the Joint Board recommendation. Among other things, the recommendation does not provide for adequate universal service support and continues implicit subsidies. In addition, the plan does not permit incumbent LECs to recover their legacy costs. The Commission must also carefully delineate the size of and mechanism for calculating the universal service fund. Finally, the Commission needs to reign in the Joint Board's proposed subsidies of

non-telecommunications businesses, such as the Internet and “internal connections,” in implementing the schools and libraries provisions of Section 254.

Our comments make the following points:

- The Joint Board’s approach to proxy modeling underestimates our costs. Any model adopted should allow us to recover our legacy costs and a reasonable share of joint and common costs;
- The Joint Board’s nationwide pricing benchmark is likely to be unreasonably high because it includes discretionary and access service revenues, and thus will undercompensate carriers for their universal service support and inappropriately preserve implicit subsidies;
- The Commission must make explicit the size of and the precise formula for assessing contributions to the high cost fund;
- The Commission must allow carriers to pass on their universal service contributions to customers;
- We support a universal service fund based on both intra- and interstate revenues which is sufficient to cover our support obligations;
- The Commission should clarify how users of unbundled elements will receive universal service distributions; we advocate dividing the subsidy between the retail and wholesale carriers;
- We oppose a reduction in the cap on Subscriber Line Charges. We also believe that if any reductions in access charges come about as a result of the upcoming access reform docket, they should be reflected in greater allocations to the universal service fund;

- The Commission should reject a rule prohibiting disconnection of Lifeline customers for non-payment of toll charges; market-driven solutions will be much more effective in keeping customers on the network;
- We support the Joint Board's discount structure for schools and libraries, but oppose the inclusion of Internet access and internal connections; in addition, the Commission must determine how the \$2.25 billion fund will be divided among eligible schools and libraries; and
- We oppose any requirement that we build out our network to provide rural health care services, and advocate equalization of distance-sensitive *rates* but not the mileage against which those rates are applied.

II. THE JOINT BOARD'S RECOMMENDED DECISION, IF ADOPTED, WILL VIOLATE THE STATUTORY MANDATE FOR ENSURING SUFFICIENT UNIVERSAL SERVICE SUPPORT FOR RURAL, INSULAR AND HIGH COST AREAS

The core function of "universal service" is support for rural, insular and other high cost areas. The statute requires that this funding mechanism be sufficient, predictable and explicit.<sup>1</sup> Unfortunately, the mechanism recommended by the Joint Board does not satisfy any of these requirements.

In brief, the Joint Board recommended that eligible telecommunications entities would draw from the high cost fund based on the difference between an estimate of their costs, as determined by a cost proxy model, and a national pricing benchmark. While the Board declined to recommend the use of any specific model at this time, it did enunciate several criteria -- including the use of

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<sup>1</sup> 47 U.S.C. §§ 254(b)(5), 254(e).

forward-looking, least-cost technology<sup>2</sup> -- to govern the ultimate selection of such a model. It also indicated that it would identify a preferred model prior to the Commission's ruling on the Board's recommendation. ¶¶ 269, 281-282.

The Joint Board further recommended that the national benchmark be calculated on the basis of total revenues-per-line, including the revenues of certain services that would not be supported by the fund. This benchmark is to be computed by dividing local, discretionary and access service revenues by the number of loops served. ¶ 310. The resulting figure will establish the revenue expectation against which support requirements will be measured.

The Joint Board's formulation does not meet the criteria delineated in Section 254 of the Act for a new universal service mechanism, because it will both substantially underestimate the costs of providing the services subject to universal service support and overestimate the revenue benchmark. The resulting cost-compensation squeeze inevitably will deny necessary universal support to deserving rural, insular and high cost areas.

First, the quality-service-at-affordable-rates mandate of (b)(1) cannot be satisfied because an eligible entity will not be able to maintain its network and keep rates affordable without

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<sup>2</sup> The Joint Board's criteria for establishing a cost model are: (1) the least cost, most efficient technology that is currently available using existing ILEC wire centers should be used; (2) any network function or element must have an associated cost; (3) forward-looking costs should be used; (4) the model should utilize forward-looking cost of capital and recovery of economic depreciation expenses; (5) costs of providing service should include all customers, including multi-line businesses; (6) a reasonable allocation of joint and common costs should be allowed; (7) the model and underlying data should be available for all interested parties to review; and (8) the model should be verifiable and relevant data inputs should be mutable. *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, *Recommended Decision*, ¶ 277 (Jt. Bd., rel. Nov. 8, 1996) (citations to the Joint Board's Recommendation hereafter are cited as "¶ \_\_," e.g., ¶ 277).

adequate universal service support.<sup>3</sup> Second, access to advanced services under (b)(2) will be threatened because insufficient support undermines network modernization efforts.<sup>4</sup> Third, the requirement in (b)(3) that services be available in rural areas at rates comparable to those in urban areas cannot be achieved with the Joint Board's methodology.<sup>5</sup> Fourth, the principle embodied in (b)(4) that universal service be supported by equitable contributions from all telecommunications providers will be violated because a disproportionate share of universal service support would have to come from the ILEC, its customers and its shareholders under the Joint Board's formulation.<sup>6</sup> Fifth, the Joint Board Recommendation will lead to the provision of insufficient support and the creation of unpredictable and hidden support flows contrary to the dictates of (b)(5).<sup>7</sup> Accordingly, the recommended support mechanism must be substantially revised by the Commission if it is to fulfill the universal service goals embodied in the Telecommunications Act. The specific areas that lead to this result are detailed below.

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<sup>3</sup> Section 254(b)(1) provides "Quality services should be available at just, reasonable, and affordable rates." If a state commission continues to insist on keeping local service rates low, the eligible entity will have to reduce maintenance and investment in the network, thereby severely undermining universal service.

<sup>4</sup> Section 254(b)(2) provides "Access to advanced telecommunications and information services should be provided in all regions of the Nation."

<sup>5</sup> Section 254(b)(3) provides "Consumers in all regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas, should have access to telecommunications and information services, including interexchange services and advanced telecommunications and information services, that are reasonably comparable to those service provided in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas."

<sup>6</sup> Section 254(b)(4) provides "All providers of telecommunications services should make an equitable and nondiscriminatory contribution to the preservation and advancement of universal service."

<sup>7</sup> Section 254(b)(5) provides "There should be specific, predictable and sufficient Federal and State mechanisms to preserve and advance universal service."

A. Implementation Of The Joint Board's Cost Model Principles Inevitably Will Understate Universal Service Costs

Under the Joint Board's formulation, the choice of a cost model will be a critical element in determining whether an ILEC will receive an adequate amount of universal service support. Although Pacific applauds the Joint Board's efforts to promote the creation of an improved model, a number of its recommendations remain seriously flawed and consequently will unreasonably deny recovery of legitimate ILEC costs. Pacific submits that, in order to comply with the dictates of Section 254 of that Act, the model must: (1) allow ILECs to recover their legacy costs; (2) predict forward-looking costs based on actual ILEC data (if the Commission adopts a forward-looking cost model); (3) use consistent cost and demand figures; (4) include joint and common costs; and (5) be auditable, verifiable, and include mutable data inputs for relevant variables.

1. All ILECs Must Be Provided An Opportunity To Recover Their Legacy Costs<sup>8</sup>
  - a) The Commission Must Permit Recovery Of Legacy Costs To Fulfill The Government's Part Of The Universal Service Bargain It Made With Carriers Of Last Resort

The Joint Board Recommendation, if adopted, would break a long-standing contract between government and local telephone companies. Government -- at all levels -- assured telephone companies that they would receive a fair opportunity to recover their legitimately incurred costs, including a fair return on investment. This promise was made in exchange for the ILECs' commitment to provide quality service to all consumers at the prices mandated by regulators. Those prices often reflected social rather than economic policies and relied on the promise of a sustainable monopoly to defer recovery and keep rates below cost. As carriers of last resort, the ILECs have created the best

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<sup>8</sup> Legacy costs are the costs associated with recovery (and in the interim, return on investment) for past investments in plant and equipment, previously found to be used and useful and includable in the ratebase for the purposes of providing regulated telecommunications services.

telecommunications system in the world, serving close to 95 percent of households and meeting high quality standards.<sup>9</sup>

In order to uphold their part of the bargain, ILECs had to invest billions of dollars in state-of-the-art plant and equipment. In accordance with generally accepted accounting principles, they sought to depreciate that plant and equipment over a reasonable period of time. But, commissions required that these investments be depreciated over a far longer period of time than prudent accounting practices would have dictated for ratemaking purposes, thereby constraining capital recovery for extended periods.<sup>10</sup> Because ILEC rates were set to recover their plant and equipment in accordance with the regulators' imposed schedules, ILECs continue to have massive undepreciated plant and equipment on their books. Pacific alone has \$ 4.7 billion in unrecovered depreciation that is in excess of accepted economic depreciation methods.<sup>11</sup>

The Joint Board's recommendation reneges on this long-standing agreement.<sup>12</sup> Absent a universal service cost model that accurately reflects actual ILEC costs, those costs will be unrecoverable in the new competitive environment. Neither the Telecommunications Act nor the constitutional prohibition against uncompensated takings will countenance such a result. It follows

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<sup>9</sup> See, e.g., Pacific Bell ARMIS Quality of Service Report No. 4305, Fourth Quarter 1995 Report, dated April 1, 1996.

<sup>10</sup> Re Pacific Bell, D.94-12-003, 57 CPUC 2d 572 (1994).

<sup>11</sup> R.95-04-043/I.95-044, Report Accompanying Prepared Testimony of Peter A. Darbee for Pacific Bell Before the California PUC, Exhibit No. 99, p. 9 (October 10, 1995).

<sup>12</sup> *Duquesne Light & Penn Power Co. v. Barasch*, 488 U.S. 299, 315 (1989) ("a State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions."). If the Commission does not address how carriers recover their legacy costs in this proceeding, it should do so in the upcoming access reform proceeding or elsewhere.

that any cost model ultimately adopted by the Commission must include recovery of ILECs' legacy costs.

b) In The Alternative, The Commission Should Adopt A Transitional Mechanism To Permit Recovery Of Past Legacy Costs

Even if the Commission decides to adopt a cost model that is based on forward-looking rather than historical costs, it should still permit a transitional recovery of legacy costs for the ILECs. In such an event, Pacific proposes that the Commission establish a separate six-year transition mechanism designed to compensate ILECs for their legitimately incurred costs without harming competition or consumers. Under this proposal, ILECs would be permitted to withdraw amounts from the high cost fund based on their legacy costs.<sup>13</sup> This recovery, however, would not be available for CLECs that win over ILEC customers.<sup>14</sup> High cost assistance for CLECs would be governed by the forward-looking mechanism that will govern all eligible entity withdrawals from the high cost fund. Pacific proposes that the mechanism be terminated in six years to coincide with the mechanism established for rural carriers. ¶¶ 283 *et seq.* That recommendation was grounded in the understanding that an immediate move to the Board's methodology could lead to relatively large changes in support levels for rural carriers.

Since rural carriers generally serve fewer subscribers relative to the large incumbent LECs, serve more sparsely populated areas, and do not generally benefit from economies of scale and scope as much as non-rural carriers, they often cannot respond to changing operating circumstances as quickly as large carriers.

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<sup>13</sup> If the FCC desires a method of verifying the accuracy of these data, it could encourage, but not require, use of ARMIS data. Given that ARMIS data are not available for all carriers and that these results may not always accurately portray an ILEC's costs in particular study areas, carriers should be given the option to use some other reasonable basis for identifying their costs.

<sup>14</sup> Subsidizing the entry of CLECs through payment of more high cost assistance than they need would distort economic incentives to enter the market, thereby harming competition.



¶ 283. In fact, the same concern holds true for other ILECs.

For the following reasons, every ILEC otherwise eligible for universal service support in rural, insular and high cost areas similarly needs a transition period to adjust to the new cost proxy model and to recover legacy costs. First, economies of scale do not enable a large carrier to recover its legacy costs. Costs of local telephone service vary by geographic area. In the new competitive environment, CLECs can target specific areas. Consequently, a large ILEC cannot respond to a changed support mechanism by engaging in massive subsidies between areas. Moreover, hiding universal subsidies by averaging costs across excessively large areas clearly violates Section 254's requirement that subsidies be made explicit.<sup>15</sup> In any event, this does not justify precluding ILECs from recovering legacy costs. Even if legacy costs per line may be on average lower than for smaller carriers (a fact which is not proven), this would not justify denying large carriers the opportunity to recover these costs.

Second, large ILECs cannot simply replace lost revenues with revenues from other services; such a policy would likewise also violate the mandate that subsidies be explicit. Third, large ILECs are less able to raise local rates to recover legacy costs than rural companies because of existing price caps. In fact, alternative access providers are far more likely to target densely populated urban areas, thereby exerting downward pressure on ILEC rates and precluding additional cost recovery. Although the subscriber base for recovery of non-rural ILEC legacy costs may be larger than for smaller companies, there is no basis for assuming that the per-subscriber amount of such costs is any

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<sup>15</sup> This also cannot be what the Commission to adopt since it has in other contexts mandated that states allow the geographic deaveraging of unbundled element rates within a state. *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98 (rel. August 8, 1996) ("First Interconnection Order"), at ¶ 764. Effectively mandating cross-state subsidies flies in the face of this policy.

smaller than that found in rural study areas. The need for a transition during which legacy costs can be recovered is, therefore, as critical for other ILECs as it is for rural ones.

Moreover, the purpose underlying Section 254 is to ensure that local service rates in rural, insular and high cost areas remain roughly comparable to those in urban areas transition. This goal simply cannot be achieved if ILECs are unable to recover from the universal service fund their higher than average costs, including legacy costs, and are, instead, forced to increase local rates or obtain a subsidy from other revenues.<sup>16</sup> It would also be arbitrary and capricious for the Commission to adopt a universal service plan that targets local rate increases only in areas served by large carriers. Therefore, the Commission should, at a minimum, adopt a mechanism for all carriers to recover legacy costs over a reasonable transition period.

2. If The Commission Adopts A Cost Model Using Forward-Looking Costs, Actual ILEC Data Must Be Used To Predict Costs

The Joint Board further errs in its recommendation that any forward-looking costs determined under an acceptable cost model be based on the least-cost, most efficient technology that is available for installation in a network using ILEC wire centers. Just as in the Interconnection proceeding, such reliance on hypothetical costs that have nothing to do with actual, expected ILEC investments is a fatal defect.<sup>17</sup> Indeed, use of the “least-cost technology” principle here is even less justifiable than in the interconnection context because the rationale for adopting a universal service mechanism is quite different from that underlying interconnection pricing.

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<sup>16</sup> In fact, this result is contradictory to the goal the Joint Board set for itself when it announced that it expected the mechanism to minimize any local rate increases. ¶ 309.

<sup>17</sup> See *First Interconnection Order*, at ¶ 683. Pacific hereby incorporates by reference its comments regarding the inadequacy of using hypothetical costs contained in Pacific’s Reply Comments, CC Docket 96-98, Phase I, at 29-32 (filed May 30, 1996).

Section 254 of the Act mandates establishment of a mechanism to ensure the availability of affordable service. The only conceivable reason to limit cost recovery in such a context is to encourage efficient investment. However, there is no reason to believe that any ILEC has failed to build its network in a rational, cost-effective manner. In reality, long-standing, state and federal price cap regulations have created strong incentives for ILECs to keep costs low. Moreover, any improvement in efficiency, such as deployment of new technology, must be phased in over time and requires significant expenditures on research, planning, implementation, and conversion. Therefore, using hypothetical "least-cost technology" assumptions in the universal service mechanism is illogical and necessarily will fail to produce adequate compensation.

In contrast, a forward-looking cost model based on ILECs' current costs<sup>18</sup> would at least ensure that an ILEC will recover its true future costs, not simply those costs associated with some hypothetical carrier. For these same reasons, Pacific endorses the Joint Board's recommendation that the ILEC's current expected cost of capital, including economic depreciation methods, be used in the model. Such variables are essential in determining an ILEC's current costs, and, therefore, the appropriate amount of universal service support.<sup>19</sup> Unlike hypothetical costs, forward-looking costs based on current costs are directly related to actual ILEC networks and to the current costs of placing and operating those networks.

One example of how some of the cost models under consideration use unrealistic assumptions is Hatfield's treatment of fill factors in a way that does not permit the provision of quality service that customers have come to depend on. Prudent network managers install spare capacity so

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<sup>18</sup> Current costs are the costs of the ILECs' networks actually deployed and operating.

<sup>19</sup> Use of forward-looking depreciation methods, of course, does not address how to recover past depreciation reserve shortfalls.

that reasonably foreseeable future demand can be served immediately and to reduce installation costs. A proper cost model must use fill factors designed to allow the carrier to fulfill the carrier of last resort obligation that defines universal service.

The use of current costs is also necessary to ensure an adequately sized fund. Reliance on hypothetical carrier costs will understate the fund, thereby depriving ILECs of full and fair compensation. Further, an undersized fund will discourage modernization in high cost areas and deter facilities-based competitors from entering the market and driving down costs. The inevitable by-product of the lack of competition is a universal service fund that does not decline because costs remain high. This certainly cannot be the result intended by Congress or the Commission. Accordingly, to work toward reducing the overall size of the universal service fund, the Commission must adequately size the fund by relying on current ILEC costs.

Pacific applauds the Joint Board's refusal to adopt the proposed Hatfield and BCM1 cost models for universal support determinations. ¶¶ 268, 279. Both of these models, as well as the various versions of Hatfield, have already been shown to be fatally flawed.<sup>20</sup> The model adopted by the Commission must permit ILECs to receive compensation for the current cost of providing universal service plus a reasonable rate of return.

An appropriate model could achieve this goal through the following methodology. The calculation of the high cost fund size should be based upon actual aggregate costs for each ILEC at the study area level. The study area level is the smallest area for which ILECs collect reliable cost data. Universal service support payments, on the other hand, would most appropriately be paid out based on smaller geographic areas, as contemplated by the Joint Board Recommendation. ¶¶ 176-78. Because

there are no actual costs available for smaller geographic units, e.g., census block groups (CBGs), a proxy model should be used to determine how to distribute the *actual*, aggregate costs calculated at the study area level to the CBG level. Thus, if a study area is made up of five CBGs with a total subsidy of \$300 for universal service, and the proxy costs for those five CBGs are \$50, \$40, \$30, \$20 and \$10, respectively, the \$300 would be distributed as follows: \$100, \$80, \$60, \$40, \$20.

Pacific is currently working with US West and Sprint to develop a "best of breed" ("BOB") proxy model. BOB takes the best features of the BCM2 and CPM to create a dynamic model within narrowly targeted geographic units. Regardless of which model the Commission adopts, as the Joint Board correctly points out, additional information must be gathered and analyzed before selecting a model. Upon identifying a model that meets the Joint Board's criteria, the Commission should seek public comment on the model. Establishing a pleading cycle is the only way to ensure a complete and accurate record and a well-reasoned decision.

3. The Commission Should Adopt The Joint Board's Recommendation That A Reasonable Share Of Joint And Common Costs Be Included In The Calculation Of Supported Costs

The Joint Board correctly recommends that the cost model should permit ILECs to recover a reasonable allocation of joint and common costs. Pacific fully supports this recommendation. As documented thoroughly elsewhere, an ILEC must be able to recover its joint and common costs to maintain and modernize its network.<sup>21</sup> Such recovery is especially necessary for universal service cost recovery, where assuring the ubiquitous availability of reasonably priced services is the mechanism's *raison d'être*.

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<sup>20</sup> See, e.g., GTE's Opposition to Petitions for Reconsideration in CC Docket No. 96-98, Phase I, at 10-14 (filed October 31, 1996).

<sup>21</sup> See Pacific's Comments, CC Docket 96-98, Phase I, at 72-73 (filed May 16, 1996).

4. Any Cost Proxy Model That Utilizes Forward-Looking Costs Must Also Use Forward-Looking Demand To Avoid Underestimating Unit Support Costs

One of the more serious problems with the Hatfield model is that it uses current demand to compute unit prices.<sup>22</sup> Unit prices are computed by dividing forward-looking costs by the demand figures, such as number of loops or minutes associated with the prices of the network for which costs are being derived. This methodology wrongly assumes that current demand will remain constant, notwithstanding the fact that competition is certain to *reduce* demand for incumbent's services significantly in the future.<sup>23</sup> Of course, there is a reason why the IXC's that commissioned Hatfield want to keep the demand figures at historical levels; the larger the demand figure used in the denominator of the unit price equation, the lower the per unit cost will be. Nonetheless, if forward-looking costs are to be adequately recovered, unit prices must be computed based on the demand that can reasonably be expected to exist in the future. Accordingly, any cost proxy model must use forward-looking demand if it is to rely on forward-looking costs.<sup>24</sup>

5. Underlying Data Used In Any Cost Model Must Be Auditable And Verifiable By Interested Parties And Relevant Data Inputs Must Be Mutable

The Joint Board required that any cost model be auditable, *i.e.*, made fully available to interested parties, including the underlying data which is entered into the model. It also declared that the results be verifiable and that relevant input variables be mutable. We fully support these recommendations.

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<sup>22</sup> Typically, unit costs are computed by taking the total forward-looking costs and dividing by the amount of units associated with a particular piece of the network, such as number of loops for loop prices or number of minutes for switching prices.

<sup>23</sup> The level of costs will also decline as demand diminishes, but it will not decline in direct proportion to demand decreases, because economies of scale will be lost and plant will be stranded.

It is axiomatic that interested parties must be able to evaluate whether a cost model is performing the way it is intended.<sup>25</sup> A corollary to full disclosure is that results need to be verifiable and relevant data inputs mutable so that the model's formulas can be tested and sensitivity analyses performed. This objective cannot be accomplished without full access to underlying support data and formulas that make up the cost model. Hatfield and its variations are defective in large part because they do not provide access to this underlying support data. They are black boxes that are mysteries to everyone but their creators.<sup>26</sup> In fact, Hatfield creators have readily admitted that they made up the underlying data when available ILEC information was not to their liking.<sup>27</sup> Even IXC's who are now

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<sup>24</sup> The only other way to correctly compute demand would be to conduct new cost studies every year so that updated demand figures can be employed. We, however, do not endorse this method and submit that cost proxy models can be designed to take into account future demand.

<sup>25</sup> The Joint Board described the Cost Proxy Model ("CPM") as flawed because it contained proprietary data and was, therefore, unavailable for review. ¶ 279. That criticism is invalid. All CPM inputs are fully available and non-proprietary. In fact, the level of public detail in the CPM is far beyond that available from other models, such as Hatfield. The underlying data of some inputs is based on Pacific Bell's actual cost data at the wire center level, and is, therefore, highly sensitive. Notwithstanding, even this data will be made available for those interested parties that sign confidentiality agreements to protect the sensitive data.

<sup>26</sup> See *First Interconnection Order*, at ¶ 794 (the FCC does not believe that the Hatfield and Benchmark Cost Model "outputs by themselves necessarily represent accurate estimates of the absolute magnitude of loop costs.") See also *Pacific Opposition to Petitions for Reconsideration*, CC Docket 96-98, Phase I, at 7-8 (filed Oct. 31, 1996).

<sup>27</sup> The public record clearly reveals the arbitrary nature of the underlying data for the inputs in the Hatfield model. See Testimony of Dr. Robert Mercer at 50, *The Board's Investigation Regarding Local Exchange Competition for Telecommunications Services*, Docket No. TX95120631 (N.J. Bd. Pub. Util., Sept. 10, 1996) (local ordinances were not reviewed to determine cable burial requirements); *Id.* at 92-95 (no workpapers, studies or other documentation supporting network fill factors); *Id.* at 95 (no documentation for network structure costs); *Id.* at 101 (no written documentation for costs of installing cables).

touting the benefits of Hatfield have argued in other proceedings that models not fully disclosed on the record are inadequate and should not be used.<sup>28</sup>

B. The Joint Board's Nationwide Benchmark Is Likely To Be Unreasonably High And Thus Undercompensate Carriers That Need Universal Service Support

As noted above, the Joint Board determined that the nationwide pricing benchmark for universal services be based on average revenues-per line by dividing local, discretionary and access service revenues by the number of loops served. ¶ 310.<sup>29</sup> The Joint Board included discretionary and access services in its universal service calculus because it assumed that the costs of providing these services were included in the cost figures derived by its cost model. ¶ 311. Pacific agrees that the appropriate per-line revenues should be used to create the nationwide benchmark. However, only those services that are supported by the universal service fund should be included in such revenues to ensure that the mechanism is sufficient, predictable and explicit as required by the statute. This formulation is also necessary to avoid the local rate increases that are inevitable if the benchmark is set too high.

1. The Cost Model Does Not Contain Costs Associated With Discretionary Or Access Services

The Joint Board is incorrect in its assumption that a cost proxy model will include costs associated with providing discretionary and access services. A properly developed cost model will include only the costs of the services studied. Given this fact, improperly including discretionary and access revenues in the pricing benchmark would artificially reduce the universal service support

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<sup>28</sup> See *Commission Requirements for Cost Support Material To Be Filed With Open Network Architecture Access Tariffs*, 7 FCC Rcd 1526, 1528 (1992).

<sup>29</sup> The Joint Board rejected other methodologies because (1) an average rate formulation would be inconsistent with the cost model methodology it intended to create, which would compute the network costs that support multiple services; and (2) an average cost formulation would fail to take into account that the revenues from other services could make the overall cost of local service affordable. ¶¶ 315-17.



available to a carrier by inflating the measure against which the carrier's model-determined costs are compared. Both CPM and the new models being explored will not consider costs associated with discretionary and access services.

2. Inclusion Of Discretionary And Access Service Revenues In The Benchmark Violates The Act's Requirement That Subsidies Be Explicit And Predictable

Even if the cost model ultimately adopted by the Commission does include the costs of providing discretionary and access services, including those revenues in the benchmark would still violate the statute's directive that support be predictable and explicit. Such a proposal would, in effect, perpetuate the existing implicit subsidy system under which the prices for discretionary and access services offset below-cost rates for local service, because revenues from discretionary and access services would offset universal service support costs. Therefore, under this mechanism, a high cost carrier may not receive universal service sufficient support because it did not provide access and discretionary services equivalent to those included in the benchmark. Revenues from the non-supported services would then defray part of the costs of local services, thus forming an implicit subsidy.

If the carrier does not or cannot sell this level of services, it could be denied recovery for its costs of providing local services from the high cost fund.<sup>30</sup> At a minimum, because demand for discretionary and access services is much more elastic than for local services, including these revenues in the benchmark would lead to unpredictable effects on a carrier's ability to obtain universal service support. These results are flatly contrary to the mandate of Section 254.

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<sup>30</sup> The FCC should also make it clear that, even if it does include discretionary and access service revenues in the benchmark, these services themselves are not eligible to receive universal service support.